No. 10784-10785

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

UNITED STATES OF AMERICA,

Appellant,

vs.

CONSOLIDATED ROCK PRODUCTS CO., a Corporation; UNION ROCK COMPANY, a Corporation, and CONSUMERS ROCK & GRAVEL COMPANY, INC., a Corporation,

Appellees.

BRIEF FOR APPELLEES.

LATHAM & WATKINS,
1112 Title Guarantee Building, Los Angeles 13,
Counsel for Appellees.

FILED
JAN 15 1945
PAUL P. O'BRIEN,
CLERK

Parker & Company, Law Printers, Los Angeles. Phone TR. 5206.

TOPICAL INDEX.

TABLE OF AUTHORITIES CITED.

Cases.

Statutes.

No. 10784-10785

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

UNITED STATES OF AMERICA,

Appellant,

vs.

CONSOLIDATED ROCK PRODUCTS CO., a Corporation; UNION ROCK COMPANY, a Corporation, and CONSUMERS ROCK & GRAVEL COMPANY, INC., a Corporation,

Appellees.

BRIEF FOR APPELLEES.

Preliminary Statement.

In this proceeding appellant seeks to reverse a judgment of the District Court for the Southern District of California.

As the two numbers indicate, there were two appeals (1) [R. 286] from a judgment of October 30, 1943 [R. 282-285] which constitutes No. 10784; and (2) the appeal [R. 334] from the judgment of April 24, 1944 [R. 330-333]. By stipulation of the parties dated May 6, 1944 [R. 347], said appeals were consolidated and the records in each were accordingly printed as one record.

The reasons for the two appeals are as follows:

Under a written stipulation of the parties [R. 47] the Trial Court first heard the issue as to whether or not appellee, Consolidated Rock Products Co., could deduct in determining its 1938 Federal income tax liability *any* amounts measured by the depreciation, depletion and amortization sustained by its subsidiary companies with respect to the latter's properties, which properties were used by Consolidated in its business.

On June 23, 1943, the Trial Court found for appellees with respect to this legal issue, saying in part [R. 263-264]:

> ". . . The principal, if not the sole, ground upon which the Government contends that the debtor was not entitled to take the deductions mentioned is that the amounts included therein constituted capital contributions from the debtor to its subsidiaries. We are unable to agree with such contention. We are persuaded that the position of the debtor is sound, and that it was entitled to be credited with the deductions taken in its return for the year 1938.
>
> "As heretofore noted it is still incumbent upon the parties to make a final computation respecting the amounts of such deductions."

From this ruling appellant took the first appeal, No. 10784.

Thereafter a further hearing was held and the Trial Court found that the *specific amounts* which the taxpayer corporation was entitled to deduct in determining its 1938 income tax liability on account of the depreciation, depletion, and amortization of the properties used by taxpayer

in its business amounted to $78,539.30 [App. Br. p. 12; R. 323, 325-328].

From this judgment appellant took its second appeal, No. 10785.

It should be noted, however, that appellant apparently does not object to the *amount* of the deduction allowed by the Trial Court. Instead, it objects to any allowance for said items or any of them.

Opinion Below.

As stated by the appellant in its Brief, page 1, the District Court did not render a formal opinion in this cause. It is respectfully requested, however, that the Trial Court's Memorandum of Conclusions, which will be hereinafter referred to, be carefully read [R. 262-264].

Jurisdiction.

The appellant in its Brief, page 2, has adequately discussed this point.

Question Presented.

Appellees entirely disagree with appellant's concept (Br. p. 2) of the "Question Presented." Appellant says:

> "During the year 1938, the taxpayer corporation *operated* seven subsidiaries under agreements which provided in part for parent to pay to each subsidiary all operating charges of the latter, including items of depreciation, depletion, and amortization. The taxpayer, which was on an accrual basis, accrued these included items on its books as a credit to the respective subsidiaries for the taxable year, but it never paid any of the amounts and *was currently denying liability thereon.*" (Emphasis supplied.)

First: As the record clearly shows, Consolidated Rock Products Co., the taxpayer corporation, did not "operate" the subsidiaries. Instead it carried on its own business, employing therein assets belonging to the subsidiaries. For the use of said assets in its business the taxpayer agreed to pay to the subsidiaries a sum to be measured by the various operating charges of the subsidiaries including the amount of depreciation, depletion, and amortization sustained by said subsidiaries with respect to their properties so leased and used by the parent.

Under the circumstances the question is whether or not the District Court erred in permitting Consolidated to deduct such amounts as business expenses within the purview of Section 23(a) of the Revenue Act of 1938.

Second: In alleging that the taxpayer "was currently denying liability" to its subsidiaries for said amounts, appellant *departs from* and seeks to *contradict* the record in this case. There is absolutely nothing in this record which by any stretch of the imagination justifies the assertion made. As a matter of fact, as will hereinafter be made abundantly clear, the Trial Court's findings specifically negative the fact alleged.

But, even if the assertion under discussion is justified as a conclusion from the evidence at hand and is not inconsistent with the facts specifically found, appellant seeks nevertheless to inject here an issue not presented to or considered by the Trial Court.

Appellant's brief, therefore, presents the further questions:

(a) May appellant claim as a *matter of fact* that the taxpayer was denying liability for the items of depreciation, depletion, and amortization heretofore referred to; and,

(b) Assuming that it may, having failed to urge the legal effect thereof below, may it now raise and argue this point before this Court for the first time?

Statement of Facts.

Appellant, of course, has accepted the various adjustments to Consolidated Rock Products Co.'s 1938 taxable income originally stipulated to by the parties before the Trial Court [R. 41, 42]. It is likewise clear that the appellant is not objecting to the Trial Court's allowance to Consolidated of an interest deduction for 1938 not theretofore allowed by appellant [R. 328]. Instead, appellant is only objecting to the items totaling $78,539.30 representing the amounts of depreciation, depletion, and amortization sustained by Consolidated's subsidiaries with respect to the various properties owned by said subsidiaries and employed by Consolidated in its business operations during 1938.

Accordingly, the statement of facts which follows will be confined to matters affecting these last mentioned items. Said statement with inconsequential changes is taken verbatim from the Trial Court's findings of fact as set forth in the Record, pages 266-277 and 326-327.

(1) The appellee, Consolidated Rock Products Co., hereinafter referred to as Consolidated, and two of its subsidiaries, Consumers Rock & Gravel Company,

Inc., and Union Rock Company, are corporations incorporated under the laws of the State of Delaware and at all times here pertinent have been duly qualified to do and have been transacting business in the State of California; their principal places of business being located in the City of Los Angeles, County of Los Angeles, State of California, within the Sixth Collection District of the State of California.

(2) Consolidated at all times has been and is both an operating and "holding" company. By the term "holding" is meant the ownership of all or a portion of the stock of various subsidiary companies engaged in the same type of business.

The relationship between the various corporations heretofore referred to appears in the Record, pages 82-83. In some cases there are two corporations bearing the same name, one being organized under the laws of the State of California and the other under the laws of the State of Delaware. Where this situation occurs, said companies are distinguished one from the other by inserting after the name and in parentheses the State of incorporation.

(3) Under date of July 15, 1929, Consolidated entered into an "operating agreement" with Union Rock Company (Delaware), Consumers Rock & Gravel Company, Inc. (Delaware), and Reliance Rock Company (Delaware) [R. 96-111]. In said agreement Consolidated is described as the "operating company" and the various subsidiary companies as the "owning

companies." Said agreement provided in part as follows:

(a) It is recited that economy and efficiency require the operation of the properties of the owning companies under one operating organization.

(b) Consolidated acquired outright all current assets (personalty) of the "owning" (subsidiary) companies.

(c) Consolidated assumed all the liabilities of the various owning companies except those based on the purchase of materials, which liabilities Consolidated could accept or reject at its option.

(d) Ownership of all fixed assets remained in the owning companies. Said operating agreement, however, vested "in the operating company for the term hereof the possession and custody" of said properties.

(e) Consolidated was authorized to make capital additions to the owner's properties. This was done from time to time by Consolidated and these expenditures appear in Column 2 of the table appearing on pages 45 and 46 of the Record.

(f) Consolidated was required to pay all operating expenses pertaining to the owner's properties, including:

> "all other operating charges and expenses of the owning companies of every sort and nature, including items of depreciation, depletion, amortization and obsolescence, which items (not involving a cash outlay)

> shall be credited to the current account of the owning companies and shall be paid to said owning companies as and when provided in Section 14 hereof, and *in consideration thereof the operating company shall be and it is hereby authorized to retain for its own use and benefit all net revenues from the operation of said properties.*" (Emphasis supplied.)

(g) The operating company was required at the conclusion of the agreement to return the capital properties belonging to the owning companies:

> "in substantially the same condition as when received by the operating company, appropriate allowance being made for any deferred maintenance existing at the effective date of this agreement as compared to that existing when said properties are returned, as well as items of depreciation, depletion, amortization and obsolescence hereafter referred to."

(h) The operating agreement here under consideration was to remain in effect until terminated by thirty days' written notice by either the owning companies to the operating company or *vice versa.*

(i) Upon the termination of said operating agreement, the properties belonging to the owning companies were to be returned to them and

> "a financial adjustment shall be made as between the operating company and any

such owning company or companies in accordance with the current account of the parties on date of return of said properties and payment shall thereupon be made in accordance therewith."

(4) Under date of July 15, 1929, Consolidated entered into a separate "operating agreement" with Builders Crushed Rock Products Company, in which the latter company was described as the "owning company" [R. 85-95]. Said agreement by its terms was substantially identical with that entered into between Consolidated and Union Rock Company (Delaware), Consumers Rock & Gravel Company, Inc. (Delaware), and Reliance Rock Company (Delaware), and heretofore referred to.

(5) On April 8, 1930, Consolidated entered into an "operating agreement" with Sunset Rock Products Company, Inc. [R. 112-123]. Said agreement by its terms was substantially identical with the two operating agreements of July 15, 1929, heretofore referred to.

(6) Immediately upon the execution of the three operating agreements heretofore herein referred to "current accounts" were established on Consolidated's books for each of said five "owning companies."

All current assets (personalty) owned by said owning companies were taken over by Consolidated and credits to the full value thereof were set up on its books for the account of each owning company. At the same time the liabilities of each of the owning companies were taken over by Consolidated and the

amount thereof charged on its books against the owning company. If the owning company's liabilities so assumed exceeded in amount the assets so acquired, there was a net charge against each owning company in the current account for each carried on Consolidated's books. If said assets exceeded said liabilities a credit to each owning company was set up on the books of Consolidated.

(7) Complementary entries were made on the books of each subsidiary or owning company. Appropriate credits and charges were made to and against Consolidated. Where current assets were acquired by Consolidated the accounts of the subsidiary reflecting said assets were closed out. The same was true with respect to the liabilities of the subsidiary taken over by Consolidated.

(8) Where capital additions were made by Consolidated to the owning company's fixed or capital assets, the amount thereof was charged on Consolidated's books to the current account of each subsidiary. Likewise, the owning companies on their books credited Consolidated with such amounts.

(9) At regularly monthly intervals beginning at the date of each operating agreement, amounts representing depreciation, depletion and amortization of leaseholds covering both assets originally possessed by each owning company and capital expenditures made on said assets by Consolidated were determined. These items were set up by Consolidated on its books as an expense of operation and a credit actually made to the current account of each owning company for said amounts representing depreciation, depletion and

amortization applicable to said assets. The amount of these items appeared on Consolidated's books at the close of each month from the beginning to the present, including each month of the year 1938 and at the close of the year 1938 as an unqualified liability to each subsidiary or owning company.

The books of account of each owning company for the same period also showed said amounts representing depreciation, depletion and amortization of leaseholds as a definite and unqualified account receivable and an asset due from Consolidated.

(10) During this entire period and including the year 1938 Consolidated and all of said owning companies (including those to be referred to in the succeeding paragraph hereof) maintained their books of account and prepared and filed their Federal income tax returns on what is known as the "accrual" basis. Said entries were made and said accounting procedure heretofore specified was followed in accordance with the terms of the operating agreements heretofore referred to herein.

(11) The procedure heretofore referred to with respect to the fixed assets owned by the five operating companies covered by said operating agreements was followed exactly with respect to the assets of two other subsidiary companies of Consolidated, namely, Union Rock Land Company, a wholly owned subsidiary of Union Rock Company (Delaware) and Atlas Mixed Mortar Company.

While there was no written operating agreement covering the ownership and use of the properties of said Union Rock Land and Atlas, the treatment ac-

corded said companies and their assets was in all respects identical with that accorded the owning companies herein referred to.

In other words, all seven companies for all purposes were treated alike.

The conduct of the parties indicates that they intended to and did enter into a contract covering the ownership and use of properties of said Union Rock Land Company and Atlas Mixed Mortar Company substantially identical in terms with the written operating agreements with the other named "owning companies" dated July 15, 1929, and April 8, 1930, and heretofore referred to.

(12) Under date of February 16, 1933, Consolidated herein entered into an agreement with Union Rock Company (Delaware), Consumers Rock & Gravel Company, Inc. (Delaware), and Reliance Rock Company (Delaware), which agreement was termed a "Modification of Operating Agreement" [R. 124-130].

No similar agreement was ever entered into between Consolidated and Builders Crushed Rock Products Company, Sunset Rock Products Company, Inc., Union Rock Land Company, or Atlas Mixed Mortar Company.

Said so-called modification agreement of February 16, 1933, provided in part:

> (a) Depreciation (including depletion and amortization) was to be actually credited only upon the termination of the agreement. Its amount was then to be determined by appraisers

to be appointed by the contracting parties and was to be based on values and rates determined as of April 1, 1929, and each succeeding year during the life of the operating agreement.

(b) The term of said operating agreement was to be five years from February 16, 1933, except that:

> "operating company is hereby given the option to extend said operating agreement as hereby modified for a further term of five years upon the same terms and conditions provided that notice of its intention to extend said term is given to each of the owning companies within one year of the date of expiration of the original term in this paragraph specified."

No notice of an extension as heretofore referred to was ever given by Consolidated or any other person, nor was any agreement with respect thereto entered into.

(13) Said so-called "Modification of Operating Agreement" heretofore referred to was ignored for all purposes by all the parties thereto. No change of any kind or nature was made by any party to said agreement in the accounting procedure theretofore established and heretofore referred to. Consolidated continued to credit amounts representing depreciation, depletion and amortization of leaseholds monthly to each subsidiary exactly in accordance with the provisions of the original operating agreements.

When the five-year term provided for by said so-called "modification" expired, no appraisers were ap-

pointed and no effort was made to determine Consolidated's liability for depreciation as provided therein, and nothing has been done with respect thereto up to the present.

(14) The conduct of the parties to said modification of operating agreement of February 16, 1933, indicates that they intended to and did in fact immediately rescind said agreement by complete abandonment of its terms. Said agreement for the purpose of this proceeding never became operative.

(15) On May 24, 1935, petitions for the reorganization under Section 77B of the Bankruptcy Act, of Consolidated and its two subsidiaries, Union Rock Company (Delaware) and Consumers Rock & Gravel Company, Inc. (Delaware), were filed in the District Court of the United States for the Southern District of California, Central Division. By appropriate order Consolidated was temporarily continued in possession of the assets of all three corporations.

No petition involving receivership, bankruptcy or reorganization has ever been filed covering the remaining so-called "owning companies," namely, Builders Crushed Rock Products Company, Sunset Rock Products Company, Inc., Reliance Rock Company and Atlas Mixed Mortar Company, or Union Rock Land Company.

(16) Under date of July 2, 1935, the Court, by appropriate order, continued Consolidated in possession of all properties, including those of the two subsidiaries just named, Consumers and Union, until further order of the Court. No contrary order has been entered by the Court.

Said order of July 2, 1935, in substance authorized Consolidated to continue existing business and financial agreements, arrangements and relations between Consolidated and its subsidiaries "to the extent that they may be necessary or advisable in order that the properties of Consolidated and its subsidiary corporations may be operated as nearly as possible under the same policy of management." Said order of July 2, 1935, has remained in full force and effect.

(17) Upon the filing of the petition for reorganization heretofore referred to the books of account of Consolidated and said Union and Consumers companies were closed as if May 24, 1935, were the end of the fiscal year of said corporations. New accounts were thereupon set up beginning May 25, 1935.

Prior accounting practices were followed exactly with respect to all of said "owning companies." The current accounts of said owning companies and Consolidated were credited and debited monthly with amounts representing depreciation, depletion and amortization, all as heretofore set forth in detail.

The procedure just referred to has been followed consistently to the present. Statements duly filed with this Court show the operations of Consolidated have consistently reflected the procedure herein referred to. In so conducting its affairs Consolidated has complied with the provisions of the order of this Court of July 2, 1935, heretofore referred to.

(18) In its Federal Corporation Income and Excess-Profits Tax Return for the calendar year 1938 [R. 58] Consolidated, on line 22 thereof, deducted an item entitled "Expenses paid for subsidiaries—$484,-

214.40." Said amount included items totaling $215,-917.64, representing the amounts of depreciation, depletion and amortization sustained by the so-called "owning companies" with respect to their properties. The details with respect to said amount of $484,-214.40 appear on page 77 of the Record. Said amounts were computed and determined in accordance with the provisions of the various operating agreements dated July 15, 1929, and April 8, 1930, and were set up on the books of Consolidated as expenses of operation, and on the books of the owning companies as accounts receivable, all as heretofore herein set forth.

(19) The United States, the claimant herein, has disallowed as deductible expenses to Consolidated all of said $215,917.64 being a part of said item of $484,214.40 as set forth above, and adjusted Consolidated's taxable income for the year 1938 accordingly. Based upon said adjustment, the United States, on November 28, 1941, assessed against Consolidated additional income taxes for the calendar year 1938 in the amount of $25,112.72, plus interest thereon to November 28, 1941, in the amount of $4,071.70.

(20) On March 9, 1942, this Court entered an order granting leave to the United States to file its claim in this proceeding for said alleged 1938 income tax deficiency together with interest thereon. Said claim was filed by the United States on March 27, 1942. Objections to the allowance of said claim either in whole or in part were duly filed by Consolidated.

(21) After the second hearing heretofore referred to under the caption of "Preliminary Statement" the

Trial Court made additional findings as to the correct amount of the disputed deductions as follows:

(a) The depreciation sustained by Consolidated's various subsidiary companies for the calendar year 1938 and which Consolidated is entitled to deduct as an expense in determining its taxable net income for the calendar year 1938 is $64,253.52.

(b) The depletion sustained by Consolidated's various subsidiary companies for the calendar year 1938 and which Consolidated is entitled to deduct as an expense in determining its taxable net income for the calendar year 1938 is $7,747.32.

(c) The amortization of leaseholds of Consolidated's various subsidiary companies for the calendar year 1938 and which Consolidated is entitled to deduct as an expense in determining its taxable net income for the calendar year 1938 is $6,538.46.

(22) Based upon the facts as above set forth and the conclusions of law grounded thereon, the Trial Court approved a recomputation of Consolidated's income tax liability for the calendar year 1938 [R. 323-324] which showed a net taxable income of $3,036.02 instead of $152,266.30 originally determined by appellant. Of the difference between said two sums, which amounts to $149,230.28, but $78,-539.30 is in controversy in this appeal. Said $78,-539.30 is made up of the three items referred to in paragraph 21(a), (b) and (c) above of this Statement of Facts.

Contentions of the Parties.

1. Appellant contends that Consolidated may not deduct, in determining its 1938 income tax liability, the items totaling $78,539.30 and heretofore referred to, because

(a) They represent capital contributions by Consolidated to its subsidiaries, and

(b) Because Consolidated was "currently denying liability" to its subsidiaries for said items and was therefore not entitled to deduct them in any event.

2. Appellees contend that Consolidated may deduct said items totaling $78,539.30 in determining its 1938 Federal income tax liability because

(a) Said items were not contributions to the capital of Consolidated's subsidiaries but instead constituted rent or compensation due to said subsidiaries from Consolidated on account of the use by Consolidated in its business of properties owned by said subsidiaries; and

(b) Under the agreement of the parties said rent was measured by the normal operating charges incurred by said subsidiaries including interest on the subsidiaries' bonds, repairs required to be made to said subsidiaries' properties and the current depreciation, depletion and amortization sustained by said subsidiaries with respect to said properties;

(c) Further, there is not a shred of evidence in the Record to justify appellant's assertion that Consolidated was denying liability to its subsidiaries on account of said items. Instead, the Trial Court's findings are directly to the contrary.

Accordingly, appellant's suggestion that this Appellate Court find a fact contrary to the facts found by the Trial Court is unwarranted and improper.

(d) Finally, even if the Record justified a finding that the liability in question was being denied by Consolidated, said point was not presented to or passed upon by the Trial Court and accordingly may not be urged on appeal as a reason for reversing the judgment of the District Court.

ARGUMENT.

Appellees' contentions just referred to will be discussed in the inverse order of their statement.

I.

Appellant's Assertion That Consolidated Was "Currently Denying Liability" to Its Subsidiaries for the Amounts Here in Controversy Is Without Merit and May Not Be Urged or Considered Here.

On pages 2 and 12 of its Brief appellant asserts without qualification that Consolidated was "currently denying" that it owed the amounts here in dispute to its subsidiaries.

To sustain this assertion of fact appellant refers not to the Record in this proceeding but to certain briefs filed with the Supreme Court of the United States in a cause entitled, *Consolidated Rock Products Co. v. DuBois,* 312 U. S. 510, 61 S. Ct. 675, decided March 3, 1941 (Br. p. 16). It also refers to certain statements made by Mr. Justice Douglas, who wrote the Court's opinion in said cause.

Admittedly the *DuBois* case had nothing whatever to do with the present income tax controversy. Instead, it was concerned only with the fairness of a plan of reorganization under Section 77B of the Federal Bankruptcy Act. Said cause was before the Supreme Court on petition to review a decision of this Court which in turn had reversed a judgment of the Trial Court (the Trial Court here) confirming said reorganization plan entered on or about *September 8, 1938.*

As heretofore stated, the Supreme Court was concerned only with the fairness of the plan of reorganization. In connection therewith, a dispute had arisen between the company's preferred stockholders and certain of its subsidiaries' bondholders. It was this controversy to which the briefs and the opinion of Mr. Justice Douglas referred. There is nothing in the Supreme Court's decision in the case heretofore referred to which indicates as a fact that on *December 31, 1938,* the end of the taxable year here in controversy, Consolidated was denying liability to its subsidiaries for the items here in dispute. As a matter of fact the Supreme Court in said proceeding of necessity had nothing before it subsequent to September 8, 1938, when the Trial Court confirmed the plan under attack. Hence, irrespective of all other considerations, *it cannot possibly be contended that at the close of its accounting year (admittedly the basic date) Consolidated was in fact denying liability for the items here in dispute.*

But, entirely apart from the point just made, appellant in its Brief has asked this Court to substitute for the Trial Court's express findings conflicting inferences of

fact drawn by another Court in an entirely different proceeding. In the instant cause the Trial Court found [R. 271]:

> "* * * The amount of these items appeared on the debtor's books at the close of each month from the beginning to the present including each month of the year 1938 and at the close of the year 1938 as an *unqualified liability* to each subsidiary or owning company.
>
> "The books of account of each owning company for the same period also showed said amounts representing depreciation, depletion and amortization of leaseholds *as a definite and unqualified account receivable* and *an asset due* from the debtor." (Emphasis supplied.)

There was, of course, no express finding by the Trial Court that Consolidated *did not* deny liability for the items in question. This was obviously due to the fact the point was not even remotely raised or considered below.

However, every fact and circumstance connected with this proceeding indicates that the liabilities in question were definite and certain at the end of the year 1938.

In view of these facts and the definite finding just quoted, it is indeed surprising that the appellant would ask this Court not only to ignore the Trial Court's findings, but to substitute therefor new and different findings based upon matters not within the Record in the current proceeding.

But, not only has appellant offended in the manner indicated; it has gone even further. It was never even remotely suggested while this proceeding was being considered below that there was any dispute as to Consolidated's

liability to its subsidiaries. In addition, it was not suggested that had such a dispute existed such fact would as a matter of law have affected the outcome of this controversy in any respect.

In other words, the legal conclusion urged by appellant from the facts assumed by appellant was not presented to the Trial Court for its consideration nor did the Trial Court pass thereon. This is made abundantly clear by the Trial Court's memorandum of conclusions where it said [R. 263, 264]:

> "The principal, if not the sole, ground upon which the government contends that the debtor was not entitled to take the deductions mentioned is that the amounts included therein constituted capital contributions from the debtor to its subsidiaries."

Despite the fact that the point now made was neither presented to nor passed upon by the Trial Court, the appellant nevertheless asks this Court to *reverse* the Trial Court because of the latter's failure to foresee appellant's present contentions.

It is too clear to require comment that appellant may do none of the things it here seeks to do. It is also clear that this Court may not consider the points so raised by appellant nor aid it in its attempt to depart from the record. *General Utilities and Operating Company v. Helvering,* 296 U. S. 200, 56 S. Ct. 185 (1935), is here squarely in point.

In that proceeding the taxpayer had declared a large dividend payable in the stock of another corporation. Immediately after the distribution of said dividend, the

taxpayer's stockholders sold the stock so received to a third party. Before the Board of Tax Appeals the Government alleged that the taxpayer derived income from the distribution to its stockholders. The Board decided this issue against the Government and upon appeal to the Circuit Court the Government urged there for the first time that the sale of the stock, although technically made by the taxpayer's stockholders after distribution, was in fact made by the taxpayer and that the profit therefrom should be taxed to it. The Circuit Court sustained the Government in this new contention and reversed the Board.

The Supreme Court, however, reversed the Circuit Court saying in part:

> "The second ground of objection, although sustained by the court, was not presented to or ruled upon by the Board. The petition for review relied wholly upon the first point; and, in the circumstances, we think the court should have considered no other. Always a taxpayer is entitled to know with fair certainty the basis of the claim against him. Stipulations concerning the facts and any other evidence properly are accommodated to issues adequately raised.
>
> "Recently (April, 1935) this court pointed out: 'The Court of Appeals is without power, on review of proceedings of the Board of Tax Appeals, to make any findings of fact. * * * The function of the court is to decide whether the correct rule of law was applied to the facts found; and whether there was substantial evidence before the Board to support the findings made. * * * If the Board has failed to

make an essential finding and the record on review is insufficient to provide the basis for a final determination, the proper procedure is to remand the case for further proceedings before the Board. * * * And the same procedure is appropriate even when the findings omitted by the Board might be supplied from examination of the record.'

"Here the court undertook to decide a question not properly raised. *Also it made an inference of fact directly in conflict with the stipulation of the parties* and the findings, for which we think the record affords no support whatever." (Emphasis supplied.)

In the case just cited the Government asked the Circuit Court to infer *from the four corners of the record before it* that the sale in question was in fact made by the taxpayer corporation and the Circuit Court made said finding. The Supreme Court found the Government's request improper and the Circuit Court's action erroneous.

In the instant case the Government seeks to go much further. It asks this Court to go entirely outside the record and to make a finding directly in conflict with the Trial Court's findings. It then asks this Court to reverse the Trial Court for not making a finding of fact nor reaching a conclusion of law which was never presented to said Trial Court in any way, shape or form. It seems too clear to require further comment that the appellant's request and action in this connection is improper and must be denied.

II.

Consolidated Was Clearly Entitled to Deduct as Business Expenses in Determining Its Net Taxable Income for the Calendar Year 1938 the Items Here in Controversy.

The issue here involved is really exceedingly simple.

As the Trial Court's findings of fact clearly show, for purposes of operating economy and efficiency Consolidated took over the physical properties of its various subsidiaries and used them in *its own business. It did not, as appellant suggests, operate the subsidiaries.* Consolidated was to retain as its own all the income accruing from the use of said properties. For said use Consolidated was to pay all the current operating expenses of said subsidiaries including interest on the subsidiaries' bonds, rentals which the subsidiaries were required to pay under separate leases, repairs to the subsidiaries' properties and the depreciation, depletion and amortization *currently* sustained by said subsidiaries with respect to said properties. In other words the measure of the amount which Consolidated was *currently* to pay said subsidiaries for the use of said properties was the sum of the items just referred to.

Consolidated reported on its 1938 tax return its gross income *from the use of its subsidiaries'* properties and treated as an expense chargeable against said income the amounts due its subsidiaries as set forth above. The deductibility of these amounts is the sole issue in this proceeding.

This simple issue was clearly understood by the Trial Court as is shown by the following observation appearing in its memorandum of conclusions [R. 262]:

> "The question of law requiring determination involves the right of the debtor to take certain deduc-

> tions in connection with its income tax return for the calendar year 1938. These deductions represent amounts which the debtor asserts it was obligated to pay to certain of its subsidiaries and that in accordance with the arrangements made between them such compensation or rent was measured by the amount of the depreciation, depletion and amortization currently accruing against said properties."

Appellant in denying Consolidated's claim is demonstrably inconsistent. Of the item of $484,214.40 deducted by Consolidated in its 1938 income tax return [R. 276] as "Expenses paid for subsidiaries" appellant allowed as deductions all but $215,917.67, which figure represented the items of depreciation, depletion and amortization. In other words, the other items, including bond interest, rent, etc., which together with the three items just mentioned made up the *measure* of the compensation to be paid by Consolidated, were allowed and the other three items were disallowed. If the depreciation, depletion and amortization represented contributions to the subsidiaries' capital why should not the other items be so treated.

On the other hand, Consolidated and its subsidiaries have been entirely consistent in the treatment accorded said items. On page 77 of the Record is shown the detail of the total of $484,214.40 deducted by Consolidated for the year 1938. Of this total $222,249.98 is shown as the amount paid Consumers Rock & Gravel Company, Inc., for the use of its properties. This sum was included as income by Consumers in its 1938 income tax return [R. 174] just as ordinary rent would have been so included. In said return Consumers deducted its own depreciation, depletion and amortization. The same procedure was followed by all the other subsidiaries.

In other words, Consolidated at no time was attempting to deduct depreciation, depletion and amortization on properties belonging to other persons, instead it was merely seeking to deduct amounts paid for the use of property, *which amounts were measured by agreed items of which said depreciation, depletion and amortization were but a few.*

Appellant's contentions with respect to these items are especially surprising in view of the fact that for more than sixteen years the regulations of the Commissioner of Internal Revenue have expressly contemplated that rent or compensation for the use of property may be measured by standards other than specific and fixed sums of money. Section 19.22(a)-20 of the regulations issued under the Federal Internal Revenue Code in effect throughout the year 1938 provided in part:

> "If a corporation has leased its property in consideration that the lessee shall pay in lieu of other rental an amount equivalent to a certain rate of dividend on the lessor's capital stock or the interest on the lessor's outstanding indebtedness *together with taxes, insurance or other fixed charges such payments shall be considered rental payments and shall be returned by the lessor corporation as income.* * * *" (Emphasis supplied.)

The above article of the regulations exactly fits the case at bar. What could be more reasonable than for the parties to agree that for the use by the parent of the subsidiaries' properties the items mentioned should be assumed and paid by the parent. As a matter of fact the agreement between the parties was an extraordinarily fair agreement. Under it the subsidiaries "broke even." Said subsidiaries

could have insisted that certain amounts in addition to the items mentioned should be paid for the use of said properties; in other words, that the subsidiaries should receive a profit. In such event the deduction to which Consolidated would have been entitled would be even greater than is here claimed. Had a fixed dollar consideration been agreed upon by the parties in advance for the use of said properties no question would have arisen and the Commissioner of Internal Revenue in fact would have allowed to Consolidated the amount claimed.

Thus viewed the issue which appellant has obscured becomes clear and the error of its contentions apparent.

Clearly none of the cases relied upon by appellant in its Brief are in point.

(a) On page 20 of its Brief, appellant cites the cases of *Majestic Securities Corp. v. Commissioner,* 120 F. (2d) 12, C. C. A. 8th (1941), and *Pennsylvania Indemnity Co. v. Commissioner,* 77 F. (2d) 92, C. C. A. 3rd (1935). In both of these cases securities were purchased from affiliated companies at more than their demonstrable market value and for the sole purpose of preserving the credit of the original owner. The Courts properly refused to permit the purchasers under such circumstances to claim losses based upon the amounts so paid for said securities. Obviously these cases have no bearing here.

(b) On page 20 of its Brief, the appellant cites *Cambridge Apartment Building Corp. v. Commissioner,* 44 B. T. A. 617 (1941), and states:

> "The then Board of Tax Appeals denied that that portion of an assessment made against

> stockholder-tenants of an apartment building used for the retirement of the assessor's bonds was income to the corporation."

With that ruling we, of course, have no quarrel. It obviously has no application here. The discharge of a bond is almost always a capital transaction. Here we are concerned only with current operating items such as interest on bonds, depreciation, depletion and amortization. Consolidated is not claiming as an item of rent any amounts required to discharge the bonds of its subsidiaries.

But, as a matter of fact, if the agreements between the parties had so provided and the total amounts which Consolidated would thus have had to pay were reasonable for the use of the properties, then even amounts so expended would be deductible. No useful purpose will be served, however, by entering into any such speculation here as the facts which form the background for the cases cited are not here present.

(c) The case of *Interstate Transit Lines v. Commissioner,* 130 F. (2d) 136, C. C. A. 8th (1942), affirmed by the Supreme Court 319 U. S. 590, 63 Sup. Ct. 1279 (1943), is likewise not in point.

In that case the parent used a portion of the subsidiaries' facilities in its interstate operations and paid an agreed rental therefor. The subsidiary, however, had intrastate operations of its own. The parent taxpayer had guaranteed the subsidiary against loss on account of all of its operations and claimed the amount of the loss so paid as a deduction against its other

income. The deduction was properly denied by both the Circuit and Supreme Courts.

The Circuit Court made the basis for the disallowance crystal clear when it said in part:

> "Assuming that the subsidiary was an agent of the petitioner as a carrier of its interstate traffic in California the absorption contract obligating the petitioner to pay the subsidiary's deficits does not *place the obligation upon the ground of payment for any service rendered or to be rendered by the subsidiary.* The amount of the deficit to be paid is not made dependent upon any corresponding unit of benefit to the petitioner or sacrifice of the subsidiary." (Emphasis supplied.)

The Supreme Court approved this analysis by saying:

> "As the Circuit Court pointed out, the assumption of the deficit was *not dependent upon a corresponding service or benefit rendered to the petitioner's business.*" (Emphasis supplied.)

The language quoted demonstrates the inapplicability of the case in question to the instant proceeding. Here the amount to be paid by Consolidated bore the most direct possible kind of relationship to the benefit derived by Consolidated. Consolidated had the benefit of the use of the subsidiaries' properties, retaining for its own all the income accruing on account of said use. What could be more reasonable than that it pay to said subsidiaries the depreciation, depletion and amortization sustained by the subsidiaries with respect to said properties.

Conclusion.

It is respectfully urged that the judgment of the District Court should be affirmed.

Respectfully submitted,

LATHAM & WATKINS,
By DANA LATHAM,
Counsel for Appellees.

January, 1945.